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Deal defaults and restructures: What have we learnt?
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What is a default?

When we enter into a loan, we weigh up the legal and financial aspects, negotiate terms, make decisions, and eventually document the loan in the form of various contracts and agreements. These documents should clearly define the parameters within which the transaction is considered to be in good standing or not.

A default on a debt occurs when a borrower does not meet any of its contractual obligations, examples of which include, but are not limited to, the following:

- a missed payment when due;
- a breach of a financial covenant (e.g. debt to assets ratio);
- receiving a qualified audit report;
- not providing agreed financial information; or
- taking on additional interest-bearing debt in excess of what is contractually allowed.

Restructuring the debt

It is inevitable that investors in the debt space will have to deal with a default at some stage, at which point the choices include restructuring of the debt, business rescue or liquidation.

The achievement of maximum recovery on the loan amount due is the lens under through which we consider these options against. Though we have found that restructuring the debt is often the best recovery option, it must form part of a solution that ensures the sustainability of the business, if not, business rescue or liquidation proceedings are then considered

This may involve:
a) raising equity capital;
b) a "haircut" (reduction) in the capital amount due on the debt;
c) extending the payment periods;
d) allowing interest to be capitalised for a period;
e) converting debt into equity; or
f) altering the interest rates payable.

Key factors to consider when restructuring a deal in response to a default

In our experience in unlisted debt we have found it useful to capture our learnings from each default, and to use these learnings to inform the way we screen future deals and to fine tune our contractual protections in the event of a default and restructure of the deal.

The following factors have played a key role in the outcome of these restructures.

1. The "who" matters

Finding a rational and practical path to a successful restructure requires all parties (notably the shareholders and lenders) to pull in the same direction. In most cases, a better overall outcome is achieved by maintaining the investee company as a going concern rather than resorting to liquidation.

The benefits of dealing with rational and solution-driven individuals – be they key executive management, shareholders or board representatives - is immeasurable. Negotiations will always be tough but if any parties are obstructive and/or lack a commercial understanding of the various stakeholder roles, the time taken to get to a solution can drag on, result in a loss of value and possibly lead to a liquidation scenario in the end.

Our experience with shareholders has shown:

- Shareholders with "closed-ended" funds are problematic. Shareholders should have access to liquidity if the business requires support.
- Large or international capital providers often exert their influence or reputation in an attempt to bulldoze the group, and can be obstructive, rather than engaging productively and proactively.
- If the restructure is a small fraction of shareholders' larger portfolio, we have seen shareholders simply taking their losses and moving on.
- Differentiating between shareholder interests and stakeholder interests during a restructure is naturally conflictual, and, as such, directors tread a fine line. The starting assumption of rationality is NOT enough – conflict management needs to be appropriately dealt with up front.

Our experience with management teams has shown:

- The timing of notifying investors (i.e. the earlier the better) can set the tone for a successful restructure. Further to this, the transparency and depth of information provided facilitates improved interaction and progress.
- Ensuring alignment of interests is key - and offering incentives to management that are matched to the achievement of turnaround targets can be useful.
- Sometimes a "clean broom" approach is the only option.

2. Timing and transparency set the scene

Transparency in the engagement at the onset, with the appropriate decision makers, is essential to the execution of a successful restructure. With this being said, engagement with the board and other key stakeholders earlier rather than later yields positive results.

3. Cash is King

Almost inevitably, a company that is breaching its debt arrangements is short of cash. The age-old adage "Cash is King" is no more evident than when in a restructure – as all capital providers are usually seeking returns, while the business needs to conserve (and raise) cash for working capital to remain in operation. This not only concerns the viability of the operations, but also whether a restructure is a viable option, or if business rescue, an orderly liquidation or a run-down scenario should be considered.

4. One size does not fit all

Finding a solution that will put the company on a positive footing could take many turns, and the answer could take many forms. As compromise amongst key stakeholders is required to achieve a successful restructure, our approach is to consider the ultimate proposal as a package - and to check whether it meets the key principles of alignment of interests; that losses are attributed appropriately in the capital structure; and that processes or people have been put in place to ensure that past operational mistakes are not repeated.

Some of the options we have considered include:

- Raising fresh equity capital to buttress the balance sheet, as well as covenants restricting dividends, share repurchases, or the pledging of assets;
- The capitalisation of interest, which provides liquidity support to a borrower, and/or a moratorium on capital repayments;
- Entering into a standstill agreement where all funders agree to not trigger a default as the restructure plans are considered;
- The conversion of debt to a preferred type instrument, or even taking a direct equity stake;
- Understanding the types of unencumbered security available, and either providing working capital underpinned by this security, or providing this security to an incoming funder; and
- Considering the sale of assets, and detailing the timing of this and the specific use of the proceeds.

5. Legal support accelerates progress

In order to maximise recovery, obtaining reputable legal support up front allows lenders to understand their rights - practically and commercially – as well as the sequence in which they are to be implemented. This can save time and eliminate unnecessary debate.

6. Report-backs rule

Regular, informative updates are critical in a restructure. These allow for parties to consider, debate and negotiate terms using the most up-to-date information as a base.

Further to this, it is important to consider whether an independent party should prepare and/or validate the information provided.

7. The fine print can minimise uncertainty

It is essential to document up front all security against the loan, as well as the process to be followed to act on the security. This allows for a full understanding of the nature of the security from the start. An informed estimate of recoverability and liquidity can then be made should a realisation process occur. And, more importantly, the requisite steps to enforce lender rights will be clear, should this be the ultimate route followed.

Further to this, where and when there is a shared security pool (i.e. with co-funders), the inclusion of an inter-creditor agreement in the deal documents is best practice, as this will clarify voting thresholds and decision-making protocols around calling a default and realising the security, thereby eliminating any ambiguity regarding lender rights.

The crux of what we have learnt

Dealing with a restructure is a time-consuming affair, which requires patience and fortitude. A restructure can be emotionally draining for the parties involved. Getting the appropriate support up front, both internally and externally, will definitely help the process, particularly as those closest to the detail may not always see the bigger picture.

Our collective experience across a host of restructures has shown that when stakeholders pull in opposite directions, the restructure is doomed to fail, making it critical to deal with conflicts at the outset. Every restructure of a debt transaction will present its own challenges, and out-of-the-box thinking will help get to an outcome that benefits all parties.

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